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Fed Fears

The Federal Reserve's announcement on June 19th of a likely early tapering of the economic stimulus bond buying program sparked a global selloff in nearly all major asset classes. All asset classes we track declined in response. Except for domestic equities, which were modestly positive for the quarter, nearly all other asset indices were negative. The Dow was up 2.3% the S&P up 2.4% and the NASDAQ up 4.2%. However, returns year-to-date remained extraordinary with the Dow up 13.8% S&P up 12.6% and NASDAQ up 12.7%. For internationally diversified equity investors, it was a down quarter. Major European and Asian indices were down roughly 2% for the quarter. EAFE was down 2.1% for the quarter and up 2.2% for the year and the ACWI ex US was down 2.7% for the quarter and up 1.2% for the year. Emerging market equity indices were significantly affected by the selloff with negative returns of 9.1% for the quarter and 10.5% for the year. Similarly, China was down 9.1% for the quarter and down 13.2% for the year. On the other hand, Japan was an outlier with a 10.3% rise for in the Nikkei 225 for the quarter and a dramatic 31.6% rise year-to-date. Fixed income indices were nearly uniformly down for the quarter. The Barclays Capital Aggregate Total Return bond index was down almost 3% for the year with the majority of the decline occurring during June of this quarter. The VIX was volatile but ended a relatively modest 16.9%. Commodities were down an average of 5%. In particular London gold declined roughly 25% for the quarter. The dollar declined 1.5% relative to the euro but rose 1.4% year-to-date. In contrast, the dollar rose 5.4% against the yen for the quarter and 15.5% for the year. New Frontier's global strategic model portfolios were down .8% to 2.8% depending on equity exposure. Bonds, international equities and emerging equities contributed significantly to the negative returns.

Perspectives

Investors have been hypersensitive to the inevitable reversal of the Federal Reserve's bond purchasing economic stimulus program known as QE3. Signs of sustainable economic recovery have been closely monitored as a harbinger of a likely end of the program. The 10-year Treasury yield hovered around 1.6% until recently. An unexpectedly positive jobs report on May 3rd sparked a mini rally with yields rising to 2% in anticipation of a positive report by the Federal Reserve scheduled for May 22nd. That report discussed improvements in the labor market as a condition of tapering of bond purchases. The minutes of the April 30-May 1 meeting also noted a number of participants expressing willingness to adjust purchases downward as early as the June meeting. On June 19th, the Federal Reserve's policy statement reflected a surprisingly positive view of

continued on page 2

About New Frontier

New Frontier is a Boston-based institutional research and investment advisory firm specializing in the development and application of state-of-the-art investment technology. Founded in 1998 by the inventors of the world's first broad spectrum, patented, provably effective portfolio optimization process, the firm continues to pioneer new developments in asset allocation and portfolio selection. Based on practical investment theory, New Frontier's services help institutional investors across the globe to select and maintain more effective portfolios.

More information is available at www.newfrontieradvisors.com.

the recovery and a likely scenario of tapering the bond buying stimulus program more quickly than previous statements. Trigger happy traders initiated a widespread selloff even as Chairman Bernanke was still speaking. Yields rose in five days to 2.6%. A global investment community was highly primed to anticipate a major decline in bond prices, rise in interest rates, and selloff of major capital market indices.

Selling in a selloff is often a very poor investment strategy unless it augurs the beginning of a radically changed investment environment. Two starkly different perspectives of the Fed's monetary stimulus policy have long been present in the minds of investors. One hypothesis, favored by many fixed income traders, held that the Federal Reserve's policies were ineffective and provided little more than overleveraging window dressing of corporate balance sheets and equity returns that would fall flat as a punctured balloon when purchasing policies ended. The alternative hypothesis, favored by many working macroeconomists, held that the Fed's stimulus policies were essential for priming the economic engine of a badly stalled U.S. economy. Low interest rates stimulate economic activity and equity values validly reflect the benefits of encouraging real economic growth. The first hypothesis implied a widespread global selloff in fixed and equity markets when the purchasing programs end while the second implied an adjustment to more normal interest rates but equity markets would likely recover near term. Recent experience favors the second hypothesis.

During the same period, China, the second largest global economy, was experiencing a massive credit crunch. The seven-day repo rate reached a peak of 11.6% on June 20th. Was China reaching a Lehman moment? The People's Bank of China's (PBOC) effort to limit runaway leveraging was causing major dislocations in fixed income markets. The stock market fell 10% in a week. Until the PBOC announced a change in policy, the stock market continued to fall precipitously. The new policy promised to provide liquidity support to any financial institution strapped for cash. China's problems have only partially been solved. The sharp decline in many emerging markets was not only driven by liquidity concerns of a tapering of the Federal Reserve's stimulus program but also of substantial financial instability in China.

The long-running saga of political dysfunction and limited European Central Bank (ECB) effectiveness continued to plague economic activity in many European markets. Cyprus and Greece credit problems have not been resolved. Nearly all major eurozone economies are in recession. The combined impact of austerity programs, cultural differences, special interests, and lack of political will are continuing obstacles without clear signs of resolution. While recent compromises over bank failures directed at avoiding the worst elements of the Cyprus crisis are welcome, many open issues are unresolved. The ECB does not have the tools available for implementing necessary monetary policy reforms and programs. To add coal to the fire, there are questions concerning the role of ECB's head, Mario Draghi, who was director-general of the Italian Treasury at the time derivative trades were

continued on page 3

New Frontier Portfolios

New Frontier develops and manages a broad range of ETF-based asset allocation portfolios for advisors and their clients, and currently oversees over \$1 billion in global ETF asset allocation portfolios.

used to delay large debt interest payments and facilitate Italian eurozone entry in 1999. It is increasingly easy to perceive the eurozone experiment as ultimately an unsustainable anchor on European growth.

Look Ahead

New Frontier's investment committee convened early in the week of the selloff to review the effects of the downturn in global capital markets on our global strategic portfolios. Contemporary Treasury yields, volatilities and correlations are explicit inputs to our optimization process. The two primary sources of return for bonds are duration and credit risk. Duration reflects sensitivity to changes in interest rates, a risk factor we have carefully monitored as a consequence of the inevitable end of the stimulus program. Credit risks tend to be more related to economic growth and equity risks. The selloff resulted in a significant shift from negative to positive correlations between stocks and bonds, limiting the diversification benefit of fixed income.

We examined all our positions with particular attention to fixed income. Short of reducing all of fixed income positions to cash, any likely scenario anticipating the selloff would likely have increased risk and decreased return. In particular, the alternative non-equity asset classes such as corporate bonds, emerging bonds and commodities declined more than treasuries during the selloff. This is because Treasuries were the dominant asset and were most resistant to negative returns relative to other non-equity allocations. The other factor, international equity investment, is an integral part of our global diversification mandate. The essential diversification structure relative to strategic objectives was remarkably stable and no significant changes were required.

Fed governors have attempted to reset the expectations of stimulus tapering since the June 19th announcement by Chairman Bernanke. Many have viewed the feral trading frenzy as overreaction. The recent downward revision of first quarter GDP growth may indicate that QE3 will be with us for some time to come. There is the continuing negative effect of the sequester to consider. Bond investing needs to conform to a changed interest rate environment with increased volatility and higher yields likely for the year.

China's policy reversal should ease credit availability and resolve some of the issues affecting the Chinese downturn, though serious problems remain. Japan's recent change in monetary and fiscal policies and its strong performance in capital markets may reflect an enhanced role in global markets. However, European securities have no obvious near-term resolution. Problems in the Middle East continue to fester. The interconnectedness of global economies elevates the risks and opportunities for everyone.

The quarter and year have been challenging for many fashionable structured and leveraged investment strategies, such as risk parity and many alternatives, purportedly resilient to market downturns. Even simple fixed risk 60/40

continued on page 4

portfolios have often dominated. Too often basic principles of portfolio optimality and long-term investing have been ignored. Michaud (1981, 2003) demonstrated that there is a limit to long-term growth in capital markets. Fully invested effectively diversified global portfolios are unlikely to miss the turnaround that is consistent with a belief in the long-term economic growth of the global economy. Leveraging and non-standard portfolio structure represent additional risks that are typically inappropriate for long-term core strategic investing.

The risk management of a well-optimized portfolio is similar to the engineering of a large building where appropriate materials, interactions, and atmospheric volatilities need to be considered. An earthquake may result in little damage to a well-designed building. The June selloff was a financial earthquake that tested the foundations of New Frontier's Michaud optimization process and found the structures highly stable and optimal within the context of its mandates.

Research News

Investors are aware that trading the current portfolio all the way to target optimal is often suboptimal. This is because the costs of additional trading to optimal may have little marginal benefit. What has been missing in investment technology is a rigorous stopping rule to determine when trading to optimal is sufficient. New Frontier's new patent application provides the first practical when-to-trade stopping-rule. The rule avoids needless trading costs but also recognizes when continued trading to target may be desirable. This technology is an application of our strategy-dependent portfolio rebalancing statistical similarity rule used in our asset management process and described further in the paper "Portfolio Monitoring in Theory and Practice," by Richard Michaud, David Esch, and Robert Michaud, published in the *Journal Of Investment Management*, 4th quarter, 2012. An authorized download of the paper is available on our website: www.newfrontieradvisors.com.

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